



Centre for Banking & Finance Law  
Faculty of Law

## Internationalization of the RMB: Implications & Challenges

*Seminar by Mr Liu Xiangmin<sup>1</sup> at the Faculty of Law, National University of Singapore, 27 September 2013*

### Seminar Report

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“You cross the river by feeling the stones.” That is how one can describe the economic liberalization in China. The same proverb can also be used to describe internationalization of the country’s currency. However, what those stones in the river are and what China’s thinking about internationalization is are still uncertain. The current understanding is that the process cannot be immediate but there are already signs that things are surely going towards the internationalization direction. At the same time, there are also signs showing that things sometimes surge backwards. When things don’t go right, the policy is actually reversed.

### **I. Background of RMB internationalization policy**

As a matter of definition, the use of the term “internationalization” is avoided and “cross-border use” is adopted. It is merely a difference between the process and outcome, internationalization being the outcome and cross-border use being the process.

There are important international and domestic events which serve as a background to the policy change on the use of the RMB. Internationally, the 2008 financial crisis created enhanced risks for traders and international investors due to the fluctuation of major currencies. This paved the call for better management of exchange rate risks especially in major importer countries like China.

Domestically, there had been a long process of discriminatory policies against the use of RMB and in favor of so-called “hard currencies.” Past policies limited the use of the RMB inside the borders. In line with a long-term policy to “export to earn foreign reserves”, companies have not been allowed to settle using the RMB.

### **II. The goal of RMB internationalization policy**

As a full international currency, the RMB is projected to be widely used and accepted as a medium of account and exchange. This will respond to several forms of usage such as trade settlement currency, investment currency, and reserve currency in international transactions of most goods and services.

The reform involves abolishing restrictions as mentioned before. People are now given an option to settle in RMB but the use of RMB to settle cross-border transactions is not mandated by government. Allowing the market forces to better decide the exchange rates and the use of the currency are preferred.

An international currency does not necessarily mean that it is a major reserve currency. History debunks the myth that there can only be one major reserve currency. The post-WWII reserve composition shows a decline of the US dollar percentage over time. Even if the RMB is going to be a reserve currency, it is not going to be a zero-sum game.

### **III. Conditions and challenges**

The benefits of using RMB are quite modest. Savings from exchange cost is fairly small. Because of better markets and innovative technology for trading and risk managements, the savings percentage may even be lower. Although the convenience factor may attract the Chinese companies to use RMB, it also requires a critical mass in order for the convenience consideration to start playing an important role in decision making.

Thus in order to incentivize companies to start using RMB, tax refund for value-added tax (VAT) currently standing at 17% is now given as an option. There is also a challenge for the importers to have a steady supply of the currency so a sizeable pool abroad needs to be developed.

This can be compared to the US dollar offshore market. The US has been a trading deficit country for a long time, which ensures a large volume of dollars in the offshore markets. Further, the Federal Reserve also signed up swap agreements with major foreign Central Banks to provide dollar liquidity to ensure the tradability of US dollars.

Similarly, China has 22 swap agreements in place at the present. They allow the borrower to unilaterally use the swap bonds with no reciprocity requirements.

The Japanese internationalization experience might prove instructive for China because of their similarity of having a surplus market. Several channels were established by Japan in order to widely circulate the Yen in the global market. Essentially, Japan had a policy of lending the Yen to foreign companies to import more from Japan. This model is now being partially adopted in China.

However, there is still an ongoing challenge to find more uses for the RMB. This calls for better investment channels that will hold the RMB and more developed markets for RMB products. In line with this, China is also opening up its domestic capital markets for qualified foreign investors. Currently, these are composed of mostly institutional investors only. This is still limited but the market is still slowly being opened up.

The development of offshore RMB market, including Hong Kong, Taiwan, Singapore and London has been steady. Several Central Banks have also decided to include RMB as part of its major foreign currency reserves.

Capital account convertibility is necessary in order for a currency to be truly international. However there is no unified standard in this regard. IMF also recognizes that there should be a closer supervision of short-term capital market flows. It must be emphasized that capital account convertibility does not equate to free convertibility. Those are two different concepts. An initial assessment shows that there are already items which are partially convertible but there are still three major restrictions on capital markets. Due to this, it is posited that it is not too far-fetched to believe that China is close to achieving basic convertibility. The risk being identified is between the currency mismatch and the size of the debt. Although it is not a present concern, it could be potentially be. This requires China to have a prudential macro supervisory framework.

The sequencing of reforms has also been the subject of numerous debates in the academic circle. The typical argument would be the liberalization of capital accounts should come prior to the liberalization of the currency. Textbook sequencing states that there are certain conditions that need to be established first, namely: macroeconomic stability, effective international regulation, sufficient reserves, and safety and solvency of financial institutions. The verdict is still out in the open whether in the actual practice, this type of sequencing should be strictly followed or it should be varied. There is no ready answer for this. It may be argued that one area of reform could be a catalyst for others. In reality, the solution is never probably textbook-based.

#### **IV. Risks of RMB internationalization**

There are a number of risks currently faced by the RMB in its internationalization process. One of these is the pressure for the RMB to depreciate to counteract the appreciation of US dollars after the phasing out of the Quantitative Easing III (QEIII) by Federal Reserve. This depreciation may stop the internationalization, according to past experience. The first risk is derived from the systemic imbalance in settlement preferences of Chinese exporters and China's trading partners. There are more Chinese companies importing foreign goods which use RMB as the settlement currency than foreign companies exporting Chinese goods using RMB as the settlement currency. This results in an imbalance. This, together with an unattractive Chinese stock market, pressures the foreign currency reserve to increase more and more.

The short term factors may have affected the incentives to hold RMB. However, if the internationalization of RMB is examined in a larger picture, taking into account the long term factors such as the relatively fast rate of China's economic growth and the macro policy of maintaining the stability of the currency in order to maintain confidence in the currency, there is room for the RMB to continue its rise.

The second risk has a lot to do with capital market convertibility. Foreign companies will have more incentive to hold and accept Chinese currency if the Chinese capital market is open to foreign investors. However, opening up the domestic capital market while it has not developed yet can be inherently risky. Though it is going to be a process, the direction is favorable towards a more open and liberal market. This will definitely encourage a more balanced cross-border use of the currency.

#### **V. Better coordination between central banks is needed**

There is also the issue of reforming of the international monetary system and coordination of major central banks in the world. Central to this issue has been the policy adopted by the US Federal Reserve to put domestic priority over international priority.

In order to achieve a better balance between domestic obligations and international obligations, there should be better coordination among the world's major issuers of the reserve currency. This will overcome the tendency of the US Federal Reserve, as national central bank which is also the issuer of the world's preeminent reserve currency, to place priority on domestic concerns over international ones in times of financial crisis.

International coordination amongst the banks has been occurring since the 2008 financial crisis. However, a unified supranational currency as a method of international coordination may not be viable in the foreseeable future given the current political set up. The alternative is to have a better coordination of policies among the world major reserve currency issuers, namely the Federal Reserve, the European Central Bank, and potentially, the People's Bank of China.

## **VI. Shanghai Free Trade Zone**

The newly announced Shanghai Free Trade Zone (FTZ) forms part of the government's ongoing efforts to reform monetary and investment policies. The most important experiments in the Shanghai FTZ are the national treatment of foreign investors and the "negative list" approach. This is so because the two experiments represent a fundamental shift in the way the Chinese government has managed foreign investment for the past two decades. In the financial areas, it is more of an extension of the current framework, including interest rate reform and opening up of the capital market. These financial reforms, however, will never equate to full convertibility. There will always be prudential regulation over cross-border movements. But with respect to basic convertibility, this might be achieved earlier than expected.

## **VII. Transparency will help alleviate apprehensions over reform**

In this present wave of reforms, transparency is more important than ever. Changing policies might produce anxiety or uncertainty for international participants. The existence of swap lines between PBOC and other central banks serves as an institutional resort if liquidity is short in the local market. This measure allows offshore participants to hedge their risk in cases of policy change or non-availability of RMB. Such swap lines are not just for prices or foreign reserves, but also for offshore transactions.

As for clearing banks that may face liquidity shortage, they can refer back to their headquarters back in China. Moreover, PBOC provides the much-needed liquidity. There shall be no pull-back on the policies. Liquidity shortage in offshore markets should not be a concern if offshore RMB markets are developed. As such, there should be more developed and broader swap lines and markets with RMB denominated assets.

Still on the private sector, there is also practical issue of the challenges faced by banks in terms of product development and commercialization and the unpredictability of policy changes. Transparency is again the key to this issue. Better communication both internally and externally should quell the apprehensions about the perceived unpredictability of policy changes.

The presenter emphasizes that the presumption of unpredictability might be misguided as further liberalization is on the way with respect to capital markets and cross-border lending, which are the two items that are important in the business of a bank. Unpredictability should also not be a concern on the issue of more policy coming out affecting the financial market, as one can predict it based on the IMF standards of convertibility.

### **VIII. The proper sequencing for reforms is still under debate**

Addressing the unpredictability concerns, however, is only one side of the issue. An assessment of the risks and the proper sequencing of reforms should also not be forgotten. Assessment is necessary to determine the extent of the risk in the opening up of capital inflows as compared to the outflows at the current stage. Understanding the relationship between capital liberalization and interest rate liberalization is also vital in making a determination of the proper sequencing of reforms. Such understanding is crucial also to avoid disastrous results for China's economy. For instance, the outpacing of the interest rate liberalization by capital liberalization might potentially lead to a surge of capital outflow from residents seeking better returns abroad. Proper sequencing of reforms will hopefully prevent the happening of this outcome.

Interest rate liberalization causes concerns not just in sequencing. Its absence also causes financial repression in China because the returns from deposits have been repressed. This also explains the surge in shadow banking in China. Currently there are equally both capital inflows and outflows depending on the business cycle. To illustrate, there are more inflows in the trading sector. The US experience on interest rate regulation and deregulation should serve as a lesson in that there should not be a sudden change in this scheme. Allowing a sudden increase in rates will encourage banks to compete with each other and take on more risky investments. In order to prevent this, there must be put in place a robust financial safety net aside from deregulation. There should be some infrastructure put in place, e.g. deposit insurance scheme, so that the eventual deregulation can be smoothed out from the process.

Possible resistance may also be felt from the state-owned enterprises against the proposed reforms due to the benefits they enjoy from a highly-regulated domestic capital market. While the existence of such resistance is inevitable, momentum towards reform should not be quelled.

### **IX. Other relevant issues**

As stated earlier, the advantage of using RMB in terms of exchange rate savings and convenience is only marginal. However, marginal advantage applies to other currencies as well which may be a consideration for low margin exporters because it might significantly impact their profitability. The bigger factor which will drive the use of RMB is the overall confidence in the Chinese economy. Based on the experience of US dollar, it is always good to have a bigger

market and more clearing centers. Singapore, being one of the first few clearing centers for RMB will obviously receive a lot of potential in terms of its future role.

The period after the 2008 financial crisis was period of turmoil. The liquidity trap which occurred post-financial crisis shined the light towards RMB's direction as an alternative international currency. With a healthy banking system, China can provide additional liquidity and contribute to a more balanced international monetary system. The differentiation between capital market financial center and clearing center will be better addressed by the interplay of government policy and market forces. However, the PBOC does not have a grand design. It is more for the market to determine the progression.

Under the current financial environment, foreign investors may have a strong incentive to hold RMB assets and this creates pressure for the RMB to appreciate. The appreciation can be further driven if the internationalization of the RMB goes too fast or too successful. Consequently, this affects the monetary policy and puts pressure on convertibility as well. It thus seems that the sequencing of the internationalization process is deeply intertwined with the abovementioned issues.

In relation to this, an argument for the simultaneous reform model over the trade and investment settlement-first and currency convertibility-second model can be made. It is a mutually reinforcing process but a sequence does not have to be strictly followed. Appreciation risk and depreciation risk will be naturally addressed by the market if the RMB has truly become market-based.

Domestic legal obstacles faced so far by the government authorities in the internationalization process are subjugated to policy choices, and any legal changes will always follow policy decisions.